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# Banks, Prices & Unemployment

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# Banks, Prices & Unemployment

By

John MacLeod

EVER since the Industrial Revolution, in addition to the normal unemployment which is an outstanding feature of capitalism, there have recurred with a dreary regularity periods when unemployment swelled to immense proportions, then, after a spell of the most acute misery for all but the wealthy, it shrank back to normal. Even before the war there were men who refused to subscribe to the orthodox explanations of this industrial phenomenon, which is known as the Trade Cycle. Mr. R. G. Hawtrey in this country was one of them and Professor Irving Fisher in America was another. Because of the theories they advanced they were regarded as heretics. But our experience of war and post-war finance has borne out practically everything they said.

Briefly, the idea was that these periodic trade depressions were not due to sun-spots, other natural causes, over-population or any of the many other theories which have held the field at one time or

another, but simply to defects in our monetary and banking systems.* The whole argument was based on the Quantity Theory of Money, which was not at that time so universally accepted as it is to-day. Our first step, therefore, must be to see what this Quantity Theory is and how it operates in practical affairs.

Let us suppose a community in which there are 100 articles for sale. If in this community the total amount of money in circulation is 100 shillings, then the average price of each article will be one shilling. Now if the amount of money in circulation is reduced to fifty shillings prices must fall until the average price of each article is sixpence. Clearly, if there is only half as much money available for spending, and there are still 100 articles, prices must fall until they are half what they were formerly. In other words, all the money in circulation at any given moment represents the total money value, or price, of all the commodities offered for sale. Consequently, if we double the amount of money in circulation prices must rise to two shillings an article. And it should be noted at this point that if some person in our imaginary community receives a sum of say, ten shillings from some outside source, and hides it away in a sock, that ten shillings will have no effect on prices as it does not come into circulation. For practical purposes it does not exist.

It will be readily seen that the foregoing results could be obtained by reversing the process and keeping the amount of money fixed while doubling or halving the number of articles for sale. And to complete a

* "This is the most distinctive feature of the banking system, that between the stock of legal tender currency and the trading community there is interposed an intermediary, the banker, who can, if he wishes, create money out of nothing." "GOOD AND BAD TRADE," R. G. HAWTREY.



rough statement of the Quantity Theory we need only add that if while keeping the *amount* of money in circulation the same as before we double the *rate of its circulation*, we are for practical purposes increasing the amount, and therefore increasing prices.

From this it will be seen that it is of first-class importance that money* should not be manufactured by anybody and everybody and the Government, realising this, long ago established a mint at which all our coin is produced and a printing establishment at which all our notes are printed. For, clearly, if anybody and everybody may manufacture money at will, then at any given moment the amount in circulation may be out of all proportion to the real wealth of the country and prices will rise steeply. While this is happening the man who suffers most is the workman whose wages habitually lag behind rising prices. But not only the workman suffers, the whole country suffers. When more money comes into circulation, when, that is, the currency is being inflated, we saw above that more will be required to purchase any article ; consequently the price-level is upset and it is this upsetting of the price-level that has such serious effects on employment. Why ?

If a man is in receipt of a salary of £20 a month, and something occurs which depreciates the £ to 15s. then his salary is thereby automatically reduced to £15 a month, in terms of purchasing power. When such depreciation occurs it applies, of course, to the whole country, and the rise in prices which is the consequence of depreciation means that all those who formerly had £20 to spend now spend only £15. In due course the price level readjusts itself to the new volume of

* I use the word "money" to denote every kind of purchasing power—coin, notes, cheques, bills, etc.

money in circulation, but it is precisely this readjustment that causes the trouble. For the new level is not reached at a bound. When the man with £20 finds that owing to a rise in prices his £20 will now go no farther than £15 did formerly, he is obliged to curtail his expenditure. He buys less from the retailer, the retailer is consequently obliged to buy less from the wholesaler, the wholesaler no longer requires so much from the factories and the factories probably reduce their orders for human labour. But the main point here is the hardship inflicted by rising prices on all who have fixed incomes.

When prices are falling the effect on trade is even worse. "Let us suppose, first, that the fall is not accompanied by any corresponding increase in the real productivity of industry: and let us further suppose for the moment that it were to be brought about at one fell swoop, without any period of transition. As consumers we should all rejoice; but those of us who were traders would soon begin to wonder how they were going to pay for their stocks of goods ordered at old prices; and those who were employers would soon begin to think very seriously about their wages bill; and even those who were wage-earners would begin to reflect that, whether or not automatically tied to the cost of living, their existing rate of money wages had been based on certain assumptions about the price-level which were no longer in accordance with the facts. Some of us would look forward to bankruptcy or heavy loss, and all of us to a good deal of unsettlement and dislocation."* Further, there is the War Debt, the interest on which is paid by taxes derived from in comes earned mainly on the sale of goods, so that if

* Money. D. H. Robertson, M.A.



prices are halved the interest payable on that debt is automatically doubled. In the quotation above it was assumed that prices dropped at "one fell swoop," but in practice of course they fall more or less gradually. The result, however, is not greatly different.

So far, then, we have seen that a disturbance of the price-level means a disturbance of employment. We have seen how, in theory, the price-level may be caused to move either up or down. We have seen that by the introduction of new purchasing power (inflation) prices rise and how by the withdrawal of purchasing power (deflation) prices fall. It will be readily realised, therefore, that the individual, or individuals, who regulate the volume of money in circulation are in an extremely responsible position. Who are these people? How, in actual fact, is the volume of money increased or decreased and why? The answers to these questions will be gathered from an account of the part played by the bank in unemployment.

* * *

It has already been said that owing to the importance of money the State reserves to itself the sole right of manufacture—in theory at least. But, strangely enough, the State has permitted private bankers to appear in the field with another kind of money—credit, which is issued in the form of cheques. This particular kind of money is brought into being in the following ways.

A merchant wishes to undertake new and costly work. He applies to his banker, to whom he is well known, produces security and receives the loan which will enable him to undertake the work. He does not, of course, go off with the money in a bag. No money passes. The amount is placed to his credit in the bank's books and he can now draw upon it by cheque

as required. The loan then appears in the balance sheet of the bank as a "deposit" too, the theory being that the merchant, immediately he receives the loan, deposits it with the banker again. A case of taking it out with one hand and putting it in with the other, so to speak. "Deposits" are therefore simply another word for "loans." (There is another kind of deposit which will be explained when we come to it.)

Credit money is also created by Bill Discounting. A British merchant sells goods to a German. When sending the goods he also sends a Bill of Exchange, which states the value of the goods and the date by which they must be paid—generally three months later. The German "accepts" the Bill, that is, he binds himself to pay at the specified time, and returns it to the Britisher. This gentleman takes it to his banker and receives the money at once, less a small charge made by the banker for the accommodation. At the end of three months the banker receives payment from the German.

The first thing that emerges then is that the banker can create money more or less at will.* And in the course of time, due to the growth of banking and the expansion of trade and industry, this credit money has grown to huge proportions. Indeed, of the total money passing through the London banks in one year, only about one per cent. is State money. It is therefore no exaggeration to say that bankers' money has largely displaced the State's money. This was recognised by the Labour Party Committee, consisting,

* "Under the system which prevails in our country there is only one method by which we can add to or diminish the aggregate amount of our money. Gold coin is no longer minted and additional paper currency is not issued except to meet the demands of the public. *The amount of money in existence varies only with the action of the banks in increasing or diminishing deposits.*" (Italics mine). Mr. R. McKenna's statement to the shareholders of the Midland Bank. See any Sunday Paper of January 27th, 1924.



among others, of Messrs. Webb, Hobson, Dalton and Tawney, which examined and reported upon the Major Douglas—"New Age" proposals. In their report "Labour and Social Credit," they say, "In modern communities, however, cheque currency is rapidly superseding cash as the common form of payment in an increasing range of transactions."

Now, all large scale industry is carried on on this bank credit, the amount created being governed not necessarily by the real industrial requirements of the community, but by the bank's reserves of cash. That is to say, experience has shown the banker that a certain ratio must be maintained between the cash in his coffers and the amount of credit he creates, the amount, that is, of his loans.

Let us call this ratio the "safety ratio," and let us suppose it to be 1 to 10. In other words, from long experience bankers know that for every £100 cash in their tills they can create credits to the value of £1,000. And as it is on this "safety ratio" that the whole case against the banks is built up, it should be remembered.

The next thing we must know some hing about, if we are to understand the problem is the Bank Rate. The Bank Rate is the rate at which the Bank of England will discount bills (an explanation of bill discounting has been given), and it governs the rate of interest on loans. When it is high, the rate for loans is high; or, to put it otherwise, money (in this case money means credit) is dear. When these rates go up the deposit rate also goes up. The deposit rate is the rate of interest received by those who lodge money in the banks, i.e., lend money to the bank. (Remember this point, it is important.) And now, armed with these few rough definitions, we may proceed.

Try to imagine the trade of the country in a fairly prosperous condition. Business is everywhere going

along smoothly, wages are relatively good, prospects seem rosy. Industry rubs its hands and thinks about expansion. Consequently it applies to the banks for the means of expanding. It produces the necessary security in the shape of title deeds, war stock, or some other recognised security, and gets the credit. Understand that no money passes. The banker simply credits Mr. Blank with the amount of the loan, gives him a cheque book and a bank pass book, and thereafter the money in circulation is increased by the amount of the loan. This is happening everywhere, of course, and soon the wheels of industry, greased by credit, spin faster and faster.

Soon everybody is employed, prices are rising because of the additional "money" in circulation, wages are struggling painfully after prices, new businesses are coming into existence, and old ones are developing, everybody is spending and buying. But "everybody" is represented for the most part by the common people, who do not deal in cheques and credit. They use cash. The result is that the great expansion of credit has caused a great demand for cash which is needed for the small everyday financial transactions—payment of wages, small accounts, shopkeepers' till money, etc. This causes a drain on the banks' reserves of cash which are, for the most part, kept at the Central Bank (Bank of England). And it is at this point that the trouble begins. For it will be remembered that it is on these reserves of cash, now being depleted by the feverish trade activity, that their loans are based. *The safety ratio has been shattered*, and something must be done.

The Bank Rate is raised steeply by the Central Bank. When this is done there are certain inevitable results, all of which lead inexorably to unemployment.



The Bank Rate now being so high, it is no longer profitable for industry to borrow from the banks. And, in any event, if industry tried it would probably be unsuccessful, as loans are now frowned upon. Industry must therefore slow down, and industry always slows down in one way. It discharges workmen. This, it is supposed, will help matters. But let us see.

The discharged workers, being deprived of their wages, reduce their orders to the retailers, who must in turn reduce orders to the wholesaler. The latter reduces his orders to the factory and the factory reduces its orders to workmen for labour. Thus the first lot of unemployment causes further unemployment and soon we get into a vicious circle from which it is almost impossible to escape.

But that is not all. The goods lying in the storehouses of industry were made when money was comparatively cheap. But money is now dear, and industry is now called upon to pay the prohibitively high rate of interest on the loans which made the goods possible. If the business is at all shaky the loans it received are called up, and it goes to the wall. That means further unemployment. The businesses that survive obviously cannot raise prices at such a time, so to make up for the high rate of interest they are paying to the banks, they reduce the wages of their remaining employees. That, it will now be clear, does not help matters. And so trade gradually declines until something positively must be done to induce sales. For sales there must be, or how is the interest to be paid to the banks? If the interest is not paid the banks foreclose. They are inexorable. This smashing of industry so that banks may receive interest on money which never existed, money which

they conjured up out of the air, is called "sound finance." Therefore, prices are lowered.

Before proceeding let us emphasise exactly what has happened. New loans have been severely restricted and in many cases existing loans have been called in. The volume of money in circulation has been reduced. The interest on loans outstanding has become very heavy and manufacturers of all kinds have been compelled to do what they most dread. They have been compelled, by the policy of the banks, to realise their stocks and thereby break prices; for their stocks come into a market in which everyone is compelled to sell and no one wishes to buy.

Now, the lowering of prices is generally regarded as a good thing, but a falling market, as has just been indicated, is not the god-send it may at first sight seem. When prices are falling we are all waiting for them to fall further before we buy; consequently, there are neither buyers nor sellers. When there are neither buyers nor sellers things, clearly, are pretty much at a standstill.

While all this is happening, there is still something else happening which contributes powerfully to trade stagnation. I have mentioned above that when the Bank Rate goes up the rate on deposits goes up with it. Indeed, the rate paid on deposits at this stage is higher than the profit rate in industry; and as money always flows to where it earns the highest rate of profit or interest, it flows into the bank instead of into industry, which it would have helped to keep going. When the money gets into the bank it is withheld from circulation to replenish the bank's depleted reserves. The purchasing power of the community is thus still further reduced, and there is an extension of the dole.



When the banks' reserves are again plentiful, the Bank Rate is reduced, and the whole silly business is gone through again. A pretty picture, is it not?

Accompaniments of the expansion and contraction of credit here described are inflation and deflation. Total price, we must remember, tends to absorb the total purchasing power in circulation; therefore, when the bankers increase the amount of money in circulation they reduce the value of money. When they withdraw from circulation their credit they increase the value of money. While this reducing or increasing process is going on, it is Hades for the workman, and, indeed, for most men. For when the value of money is decreasing, prices are rising, and wages climb very slowly and painfully after them. When the value of money is being raised (as at present), prices are forced down; but before they go down wages must go down. And it will doubtless have been noticed that they go down much more blithely than they went up.

* * *

It will now be clear that the only consideration which should count with the Central Bank in increasing or decreasing the volume of money in circulation is the effect such action will have on prices. Stable prices are an indispensable condition of stable employment. But while bankers are permitted to manufacture or destroy purchasing power at will, and while the Central Bank has unfettered power in controlling the Bank Rate, there is little improvement to be expected. Banks, the Central Bank included, are responsible to no one but their shareholders. They are private trading firms trading in, and on, the nation's credit; and their first consideration is their profits, which are

invariably huge. Mr. McKenna, Chairman of the London Joint City and Midland Bank, at the annual meeting of the shareholders on 27th January, 1925, in winding up his address said :—"The net profit for the year works out at £2,424,993, or about £200,000 more than for the previous year. If we add to this the balance brought forward we have a total of £3,222,062 available for appropriation. The Board decided to recommend a dividend at the usual rate of 18 per cent. per annum less tax." And all the chairmen of the big banks conclude their speeches in similar vein. While industry is in many parts of the country almost at a standstill the banks pursue the even tenor of their 20 per cent. way.

The remedy is obvious. The manufacture of every species of purchasing power must be a State monopoly. The State would then be in a position, by the wise manipulation of the Bank Rate, to inject money into the system when prices were falling and withdraw it when prices were rising and thus achieve that stability of the price-level without which employment cannot be stable. If this were the guiding principle in our monetary policy we should not have been subjected to the recent rise in the Bank Rate—a rise dictated solely by the desire to make a return to the gold standard easier—a gold standard which, when we get it, won't be a gold standard at all in the old sense, and even if it were would be of little use to us.* Money was evolved for the convenience of industry and the people. The bankers have, in the course of time, put industry and the people in the preposterous position of being a convenience for money.

* See J. M. Keynes' speech to the House of Commons Commercial Committee on March 18th, 1925, and reported in the "Nation" of March 21st, 1925.



## A Note on Books.

One of the best elementary books on the subject is "Money," by D. H. Robertson, Workers' Edition, 2/6. After this other books which should be read are :—

"Good and Bad Trade," R. G. Hawtrey, 6/-.

"Stabilisation," E. M. H. Lloyd, 4/6.

"A Tract on Monetary Reform," J. M. Keynes, 7/6.

"The Nature of Capital and Income," Irving Fisher, 17/-.

The annual speeches delivered by Mr. McKenna and reported in most of the papers should also be studied. They are always full of information which is helpful in this particular study.

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